
17 Europe's ground zero

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It was a stroke of bad luck that the coronavirus hit Europe first in the country that has the weakest economic fundamentals and most precarious political equilibrium. At the time of writing, Italy has the second largest number of cases (after China), the highest number of cases per capita (followed by South Korea), and the highest mortality rate (Table 1).²

Table 1 Number of cases and mortality rates in selected countries

	China	Italy	Iran	S. Korea	Spain
Number Cases	80,994	21,157	12,729	8,162	6,391
Cases per million inhabitants	56	349	151	159	137
Number of Deaths	3199	1441	611	75	196
Mortality rate	3.9%	6.8%	4.8%	0.9%	3.1%
	Germany	France	US	Switzerland	UK
Number Cases	4,649	4,499	3,045	1,375	1,140
Cases per million inhabitants	56	69	9	159	17
Number of Deaths	9	91	60	13	21
Mortality rate	0.2%	2.0%	2.0%	0.9%	1.8%

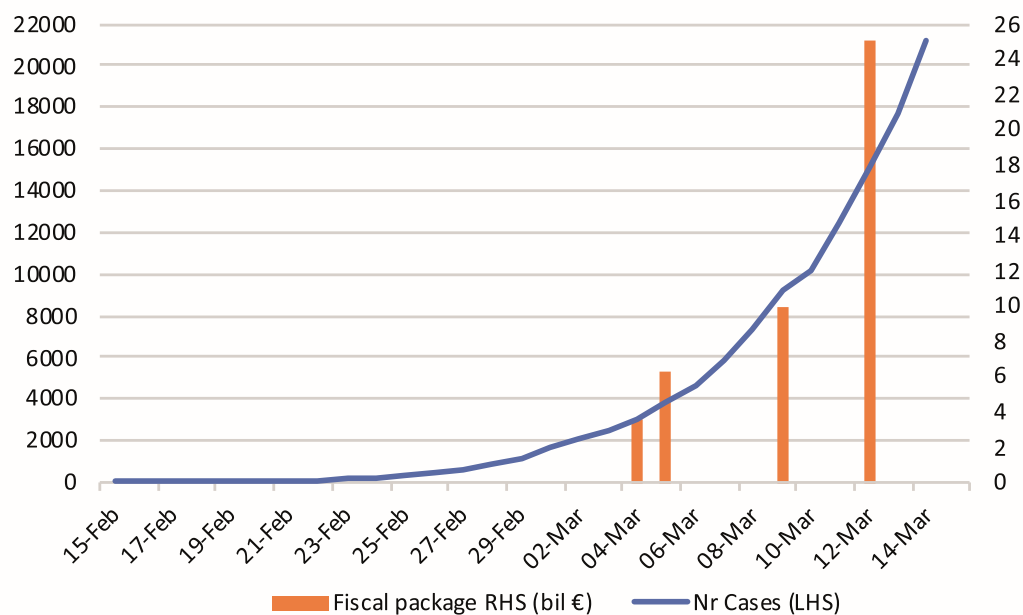
Source: own elaboration based on data retrieved on 15/3/2020 from <https://www.worldometers.info/coronavirus/#countries>

1 I would like to thank without implications Richard Baldwin, Carlo Alberto Carnevale Maffè, Tito Cordella, Mitu Gulati, Andrea Presbitero, Emilio Rossi, Angel Ubide, and Betrice Weder di Mauro for comments and suggestions.

2 For an interesting interpretation of Italy's high mortality rate, see <https://twitter.com/kuhmo/status/1238421146837684224>. It should be noted, however, that this explanation based on cultural factors is hard to reconcile with the differences in mortality rate across Italian regions described in Figure 2.

The number of cases is still growing rapidly, and it is not clear when Italy will reach the peak of the epidemiological curve; Figure 1 shows the country is still in its acceleration phase. There are large differences across Italian regions (Figure 2), both in terms of the number of infections (from more than 1,000 infections per million inhabitants in Lombardy to fewer than 50 infections per million inhabitants in most Southern regions) and mortality rates (above 8% in Emilia Romagna and Lombardy and below 3% in more than half of Italian regions, including Veneto).

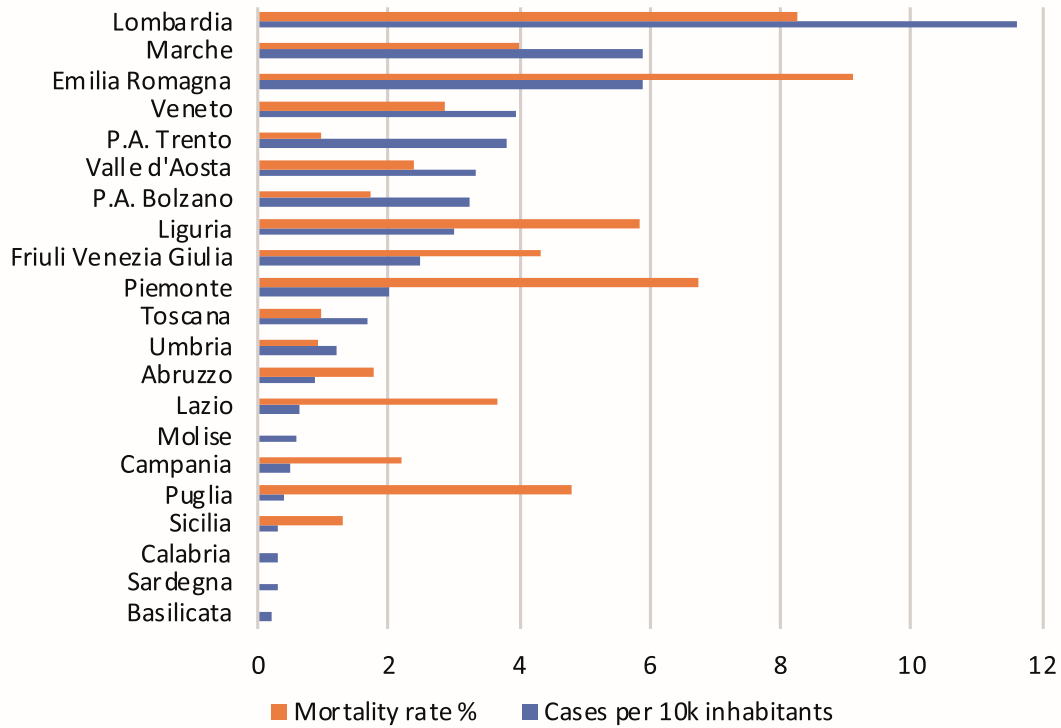
Figure 1 Evolution of infections in Italy and economic measures



Source: Infection data were retrieved on 15/3/2020 from <https://www.worldometers.info/coronavirus/#countries>. Fiscal package data are hand collected from Italian newspapers and official declarations by Italian authorities.

The rapid spread of the virus led the Italian government to impose containment policies that, in addition to closing all schools and most shops, ban all non-essential travel and public gatherings. These policies, which were announced on 12 March, expire on 3 April. It is likely that the containment policies will be prolonged to the Easter holiday period (12 April) and possibly to the end of April. Other European countries are now also tightening their own policies. The length of the containment period in Italy and in the rest of Europe will be a crucial element in determining the economic cost of this pandemic.

Figure 2 Prevalence of cases and mortality rates across Italian regions, 14 March 2020



Source: own elaborations based on data retrieved on 14/3/2020 from <https://datastudio.google.com/u/0/reporting/91350339-2c97-49b5-92b8-965996530f00/page/RdlHB>

Italy's containment policies were a missed opportunity for other EU nations

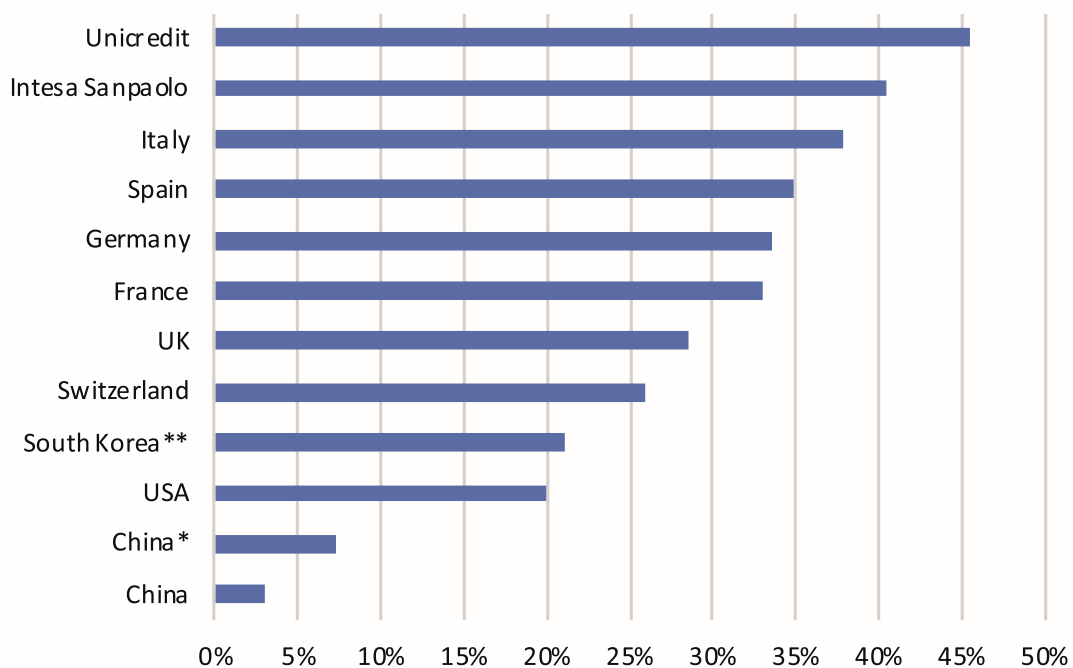
Italy's containment policies created positive spillovers for the rest of Europe. This, however, has been a mostly wasted opportunity because other European countries have been slow in reacting to the virus outbreak.

The trajectory of the spread of contagion is similar across European countries and, as pointed out by Bénassy-Quéré et al. (2020), "time lags will soon become a footnote". There are, however, at least four reasons why the economic impact could be larger in Italy:

- Low structural growth
- An economic structure that may amplify the vulnerabilities to this particular crisis
- The risk that the economic crisis may lead to a full-fledged banking and debt crisis and
- The policy response of the Italian authorities.

This higher risk is reflected by equity prices, a typical forward-looking indicator. Figure 3 shows that between 21 February (the pre-crisis peak) and 13 March, the Italian main stock index dropped by nearly 40%, with equity prices of the two largest Italian banks decreasing by 40% and 46%, respectively. While drops in equity prices were large throughout Europe, so far Italy has suffered the largest decline.

Figure 3 Percentage drop in main equity indexes and in the two Italian largest banks, 21 February to 13 March



Source: own calculation based on stock market data.

Notes: * Percentage drop between 13 January and 13 March; ** Percentage drop between 13 February and 13 March.

Low structural growth and limited fiscal space

Italy is characterised by structurally low GDP growth (over the past 25 years, average real GDP growth was about 0.6%, which is 60% lower than the euro area average of 1.6%). GDP contracted by 0.3% in the last quarter of 2019 and, before the outbreak, 2020 growth was expected to be close to 0.5%. Post outbreak forecasts predict a 2-3% contraction of GDP, depending on whether the containment policies will end on 3 April (as announced by the government) or will last until the end of April. These forecasts do not incorporate the economic spillovers of containment policies in other European countries. If the rest of Europe implements strict containment policies (France tightened its containment policies on 15 March 15) and Italian policies are extended to May, the economic contraction will be much deeper than 3%.

The crisis will lead to a rapid growth of the Italian debt-to-GDP ratio which, even in a relatively benign scenario, is expected to surpass 140% by the end of 2020. It could go much higher. Limited fiscal space will prevent the Italian government from implementing an open-ended fiscal response like those announced in the UK and Germany.³

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Moreover, when the emergency is over, Italy may require a fiscal tightening. Countries with more fiscal space and higher trend growth are likely to observe a V-shaped recession, but in Italy the recovery is likely to be slowed down by the need to keep the fiscal accounts under control.⁴

Italy's economic structure

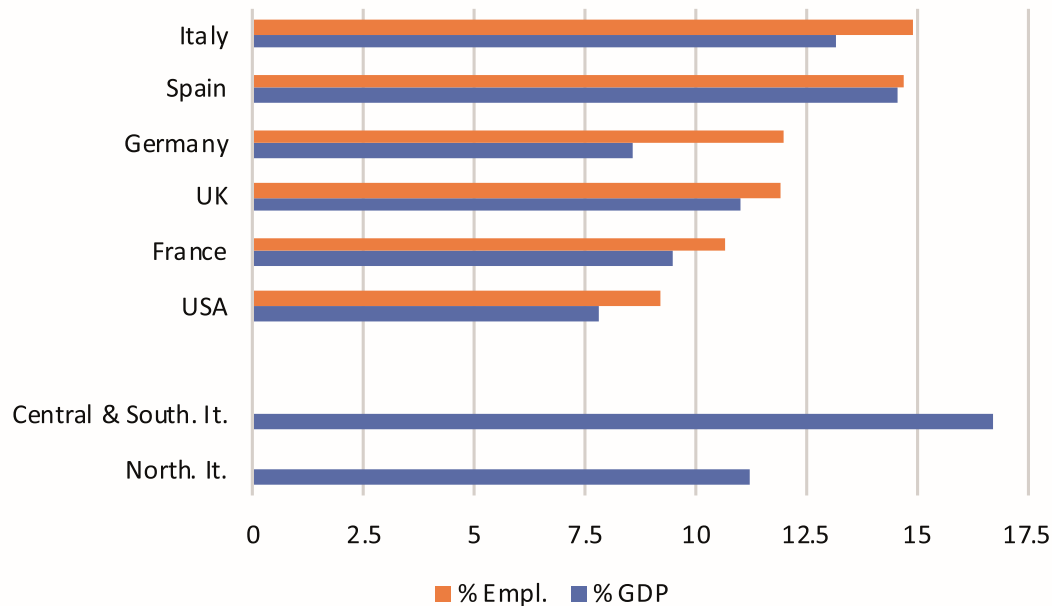
Among large European economies, Italy has the largest tourism sector as a share of employed people and the second largest as a share of GDP (Figure 4). Within Italy, tourism is particularly important in the central and southern regions which, so far, have registered a low number of cases (see Figure 2).

The negative effect of the virus will be stronger in regions with a higher number of cases. However, the regional correlation between the number of cases and their negative economic impact is likely to be stronger for the manufacturing sector and non-tourism-related services. As the whole country is locked down, the negative effect on tourism will be uniform (in proportion to the size of the sector) across the national territory. The regional concentration of the contagion in northern Italy will thus amplify its economic costs.

3 https://www.bloomberg.com/news/articles/2020-03-13/merkel-says-germany-to-do-whatever-s-needed-to-counter-virus?cmpid%3D=socialflow-twitter-politics&utm_source=twitter&utm_campaign=socialflow-organic&utm_content=politics&utm_medium=social

4 One alternative view put forward by Ubide (2020) is that fiscal space is endogenous and, with supportive policies from the ECB and its European partners and near zero global interest rates, Italy will not need a post-crisis fiscal retrenchment. Whether desirable or not, I see such post-crisis European support as an unlikely event.

Figure 4 Contribution of tourism to employment and GDP in selected countries and Italian geographical areas

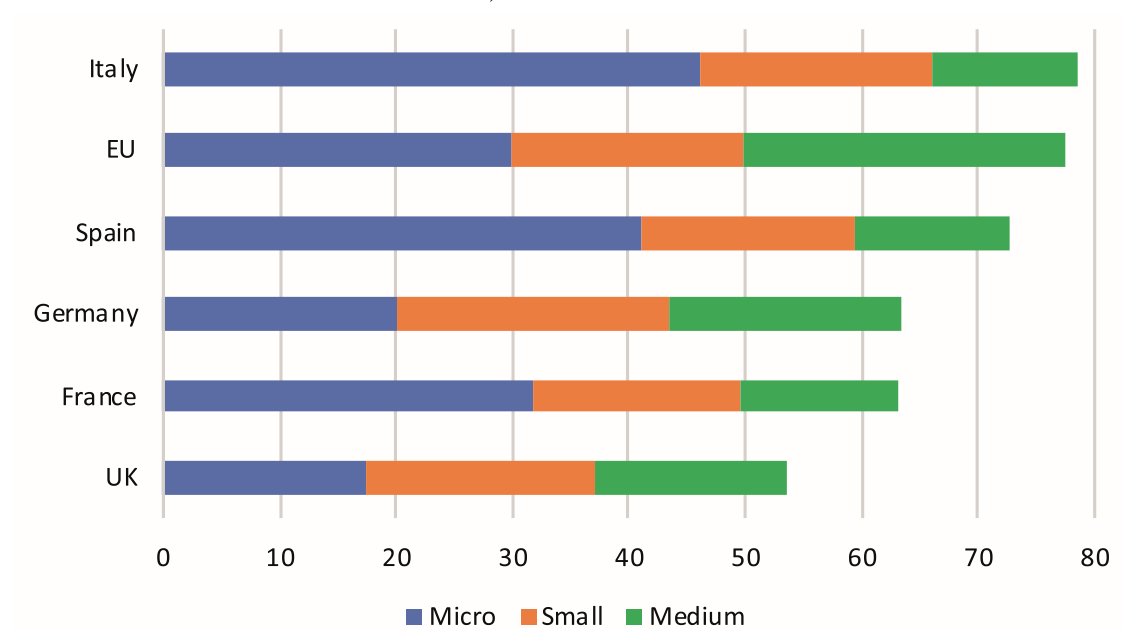


Note: The data include both direct and indirect contributions. Source: own elaboration based on data from <https://www.wttc.org/economic-impact/country-analysis/league-table-summaries/> and <https://www.ucer.camcom.it/comunicazione/notizie/pdf-2017/turismoinvisible.pdf>

There will be a stronger impact on manufacturing and non-tourism services where these sectors are more important and a proportionally uniform impact on tourism throughout the country, including in regions with a small number of cases but a large tourism sector. If the virus is not contained by the beginning of the summer, the economic cost for several coastal regions will be enormous.

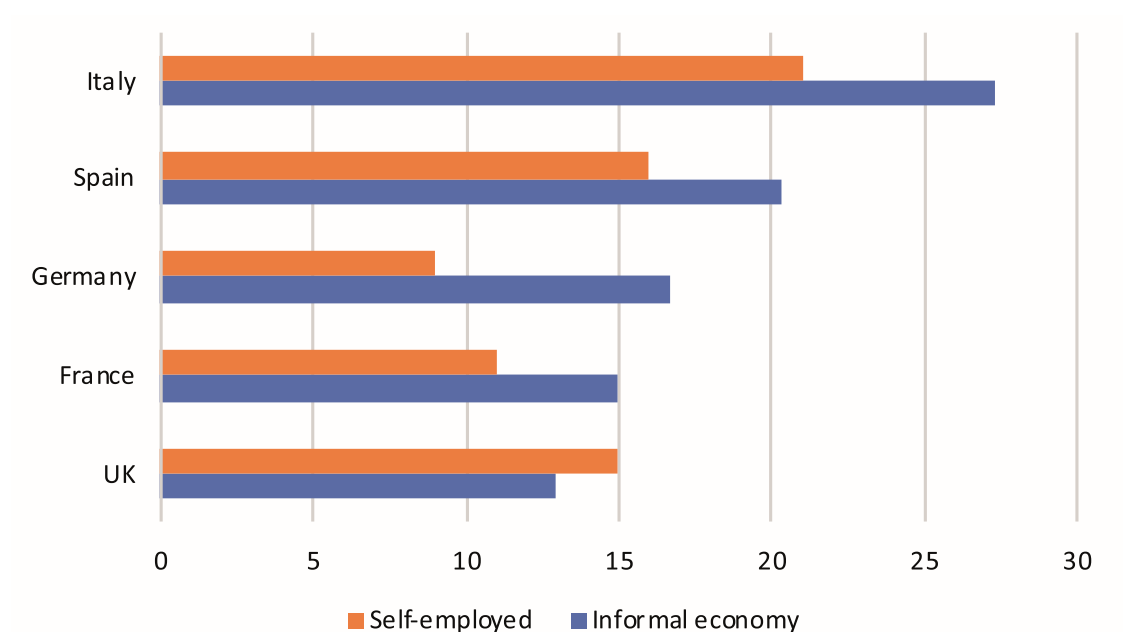
Another important structural characteristic is related to the fact that Italy has a large number of micro and small enterprises (Figure 5), a large informal economy, and a large number of self-employed workers (Figure 6). These are an important amplification mechanism because there is evidence that small and informal enterprises are more vulnerable to exogenous shocks (e.g. Fort et al. 2013), probably because they tend to have limited financial, managerial and information resources. Small and informal firms are also less likely to be able to respond to the crisis with technological solutions such as teleworking, while workers in the informal economy lack most social protection mechanisms and are difficult to reach with targeted measures.

Figure 5 Contribution of different SME size classes to employment in the non-financial business sector, 2016



Source: European Commission (2017)

Figure 6 Share of informal economy and self-employment in selected European countries



Sources: Data for informal economy are from Kelmanson et al. (2019) and refer to 2016. Data on self-employment are from <https://ec.europa.eu/eurostat/web/products-eurostat-news/-/DDN-20170906-1>

The measures implemented by the Italian government include a tax credit and tax cuts for firms with a large drop in revenues and those in the tourism and logistics sectors. They also include special zero-interest long-term loans, suspension of payments of social security contributions, additional funds for the Cassa Integrazione Guadagni, and suspension of payments on mortgages. These measures will help hard-hit small and medium enterprises in the formal sector and households with a mortgage. It is, however, also necessary to implement policies aimed at protecting self-employed and temporary workers.

From recession to financial crisis?

Recessions associated with financial crises are deeper and last longer than the average recession (Reinhart and Rogoff 2011) and Italy risks a joint banking and sovereign debt crisis – but not a currency crisis, since this is ruled out by membership of the euro area.

The coronavirus pandemic requires a decisive fiscal action and the Italian government has scaled up its fiscal response from €3.6 billion on 4 March to €25 billion on 12 March (Figure 1). This is the right thing to do. Keynesians and neoclassical economists agree that in time of crisis countries should run budget deficits.⁵ Unfortunately, Italy entered the crisis with a high level of public debt and limited fiscal space. As mentioned above, conservative estimates suggest that by the end of the year, Italy's debt-to-GDP ratio will reach 140% (the level at the end of 2019 was 133%, and the pre-outbreak forecast for 2020 was 134%). These estimates assume that GDP will contract by 3% and that the fiscal deficit will be close to 3% of GDP. However, the deficit may end up being larger and the GDP contraction deeper, and public debt may go well above 140% of GDP.

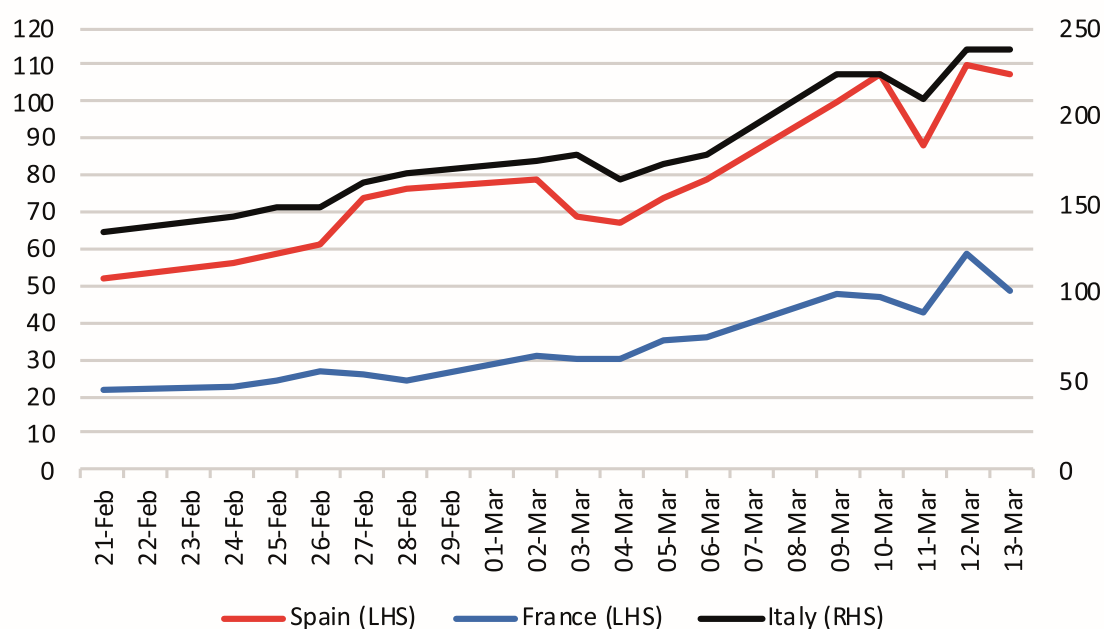
Recessions associated with financial crises are deeper and last longer than the average recession and Italy risks a joint banking and sovereign debt crisis.

If interest rates remain low and Italy does not lose access to the capital market, this increase in the debt ratio should not put debt sustainability into question. The good news is that the European Commission loosened the fiscal limits for the Italian government. The risk is that markets could take the view that Italy's debt is not sustainable.

5 Fatás et al. (2019) discuss good and bad reasons for accumulating public debt.

One key message of the literature on financial crises (e.g. Eichengreen et al. 1995) is the possibility of multiple equilibria. Investors' fears can be self-fulfilling: a sudden increase in the spread on Italian Treasuries would make Italian debt unsustainable. This is not a theoretical possibility. In November 2011, the Italian spread peaked at more than 550 basis points (and the debt-to-GDP ratio was below 120%). More recently, the Italian spread grew by nearly 100 basis points after the virus outbreak and reacted badly to President Lagarde's botched comment that the ECB "is not here to close spreads." The outbreak of the virus and Lagarde's comments were also followed by an increase in the Spanish and French spreads (Figure 7).

Figure 7 Sovereign spreads in Italy, France, and Spain



Source: own elaboration based on ECB online data

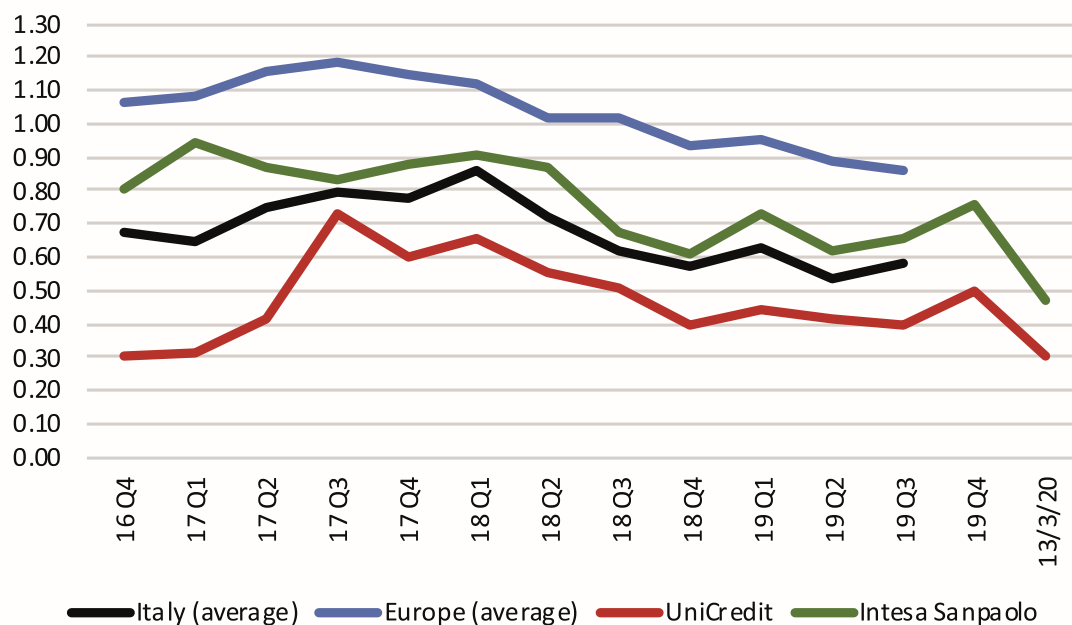
Another point of vulnerability is the Italian banking system. Italian banks have lower capital ratios than other European banks and larger shares of non-performing loans. The high risk premium and lower expected earnings of Italian banks are reflected in price-to-book ratios which, even before the virus outbreak, were well below the average of other European banks (Figure 8). A recent analysis of an Italian rating agency (Cerved Rating 2020) suggests that the crisis could push the probability of default of Italian non-financial corporate to 10%. Such a wave of bankruptcies would further weaken bank balance sheets.

While many small Italian regional banks have weak balance sheets, low price-to-book ratios also apply to the two largest Italian banks: in mid-February the price to book ratio of UniCredit was 0.5 and that of Intesa Sanpaolo 0.8 (both below the European average, plotted in Figure 8). These ratios have now collapsed to 0.3 and 0.5, respectively.

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Italian banks also hold a large amount of domestic government bonds (about one quarter of the total stock) and a sudden increase in government bond yields could put their balance sheets under further pressure and feed the ‘doom loop’ discussed by, among others, Altavilla et al. (2017).

Figure 8 Price-to-book ratios of Italian and European banks



Source: own elaboration based on Bank of Italy data.

Containment with limited testing and without tracking

After a slow start, Italy adopted aggressive containment policies aimed at flattening the epidemic curve.⁶ The economic impact of these policies will be large because, as pointed out by Gourinchas (2020), flattening the infection curve steepens the recession curve.

While Italy is being aggressive in its containment policies, it has not made much progress in the 'trace, test and treat' approach which has proven to be successful in South Korea and Taiwan, and that is also being aggressively pursued in Israel.⁷ Italy's byzantine bureaucracy has produced a paper module which individuals need to carry with them to 'self-certify' that they are outside their home for compelling business or health reasons. However, Italian authorities have not yet developed an extensive testing and tracking system.

A second wave?

While at this stage containment policies are supposed to end on 3 April, it is likely that they will be extended to the end of April, possibly to mid-May. At some point, however, Italy will need to reopen for business and, at that point, we are likely to observe a second peak of the epidemic curve. Italy was not prepared when the virus hit the country and the response was slower than in South Korea, which had put policies in place after the outbreak of Middle East Respiratory Syndrome in 2015 had caused 36 deaths. It is now critical to devise policies which will allow for extensive testing and tracking when the country reopens. Although concrete proposals exist, the Italian government seems to be moving slowly on this. Drive-through testing is already being implemented in Germany, but not yet in Italy.⁸

6 For an economist's view of the epidemic curve, see Baldwin (2020).

7 South Korea has been able to slow-down the rate of contagion and maintain low mortality rates without imposing a complete lock-down. While schools are closed and people are encouraged to work from home, South Korea has not imposed restrictions to movement like those imposed in Italy. For a description of the South Korean approach see <https://www.bbc.com/news/world-asia-51836898>

8 This is the case at the national level. One region (Veneto) seems to be following the Korean model with good results (see Figure 2) <https://www.ilsole24ore.com/art/veneto-come-corea-sud-tamponi-tutti-strade-supermercati-ADR2MND>

What is to be done?

Policy response requires action at both the national and international level.

- At the international level, the European Commission and the ECB need to make sure that the economic crisis does not become a financial crisis.

As correctly pointed out by Olivier Blanchard, this is a truly exogenous shock and:

“There is no moral hazard here, no need for punishment for past sins. Just help for a member country that needs help, which can be provided at likely zero cost, and in the process saving the euro zone... The constraints on the scope of intervention by the ECB are the capital key and a 33% limit on ECB holdings of debt of a particular country (which is not binding yet for Italy). Both are justified in normal times. Both can be suspended in exceptional times, and both should. The last thing the world needs at this juncture is another euro crisis. The ECB should and can avoid it.”⁹

Similar points are made by Bénassy-Quéré et al. (2020) and Gourinchas (2020), who adds: “If now is not the time to borrow to support an economy on the verge of collapse, when is a good time?”

As discussed in Fatás et al. (2019) wars, epidemic, and deep recessions are the textbook example for running large deficits and accumulating large debts (see, for instance the evolution of the debt-to-GDP ratio in the UK over the past 120 years in Figure 9).

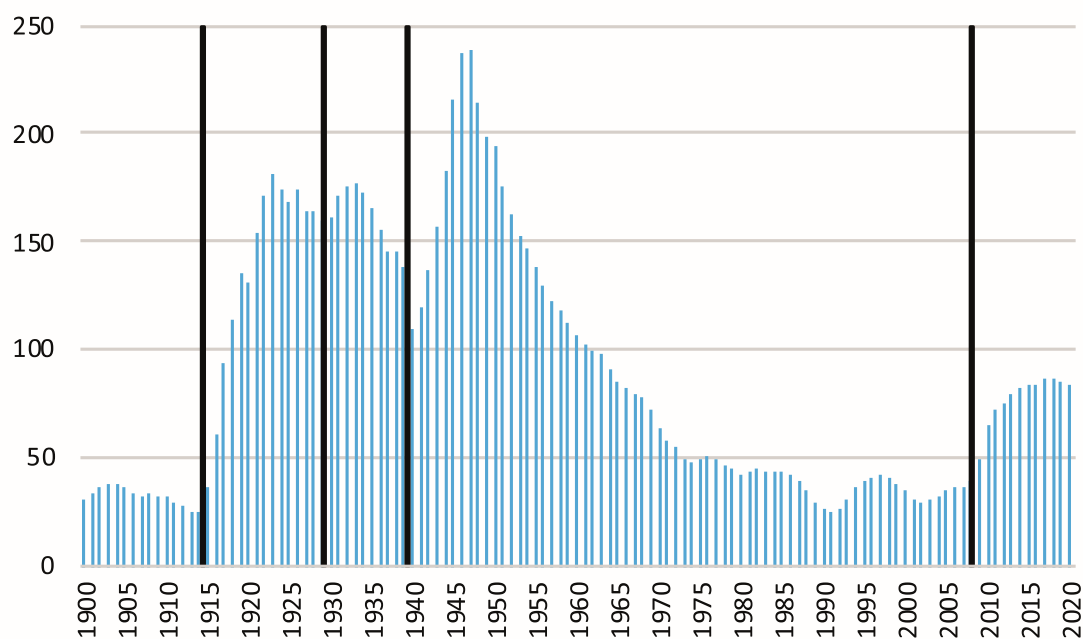
■ *Wars, epidemic, and deep recessions are the textbook examples of when a nation should run a large deficit.*

There is ample evidence that action is most effective before a crisis strikes. It is thus important that both the European Commission and the ECB send the right signals. In this sense, ECB Chief Economist Philip Lane’s statement that “[w]e clearly stand ready to do more and adjust all of our instruments, if needed to ensure that the elevated spreads that we see in response to the acceleration of the spreading of the coronavirus do not undermine transmission”¹⁰ is a clear step in the right direction.

9 <https://twitter.com/ojblanchard1/status/1238491393129136128>

10 <https://www.ecb.europa.eu/press/blog/date/2020/html/ecb.blog200313~9e783ea567.en.html>

Figure 9 Debt-to-GDP ratio in the UK, 1900-2020



Note: The vertical bars indicate the beginning of World War I, the Great Depression, World War II, and the Global Financial Crisis

Source: Bank of England

- At the domestic level, Italy could act decisively along two lines: 1) guaranteeing long-term fiscal sustainability, and 2) facilitating the return to normalcy after the acute stage of the crisis.

First, Italy should be recognised that debt sustainability is a long-term concept. A country can run large deficits and accumulate substantial debt as long as lenders believe that it will be able to service this debt in the future. In this sense, Italy could reassure investors (and northern countries worried by moral hazard) by committing to reverse two misguided policies adopted in 2019: the pension counter-reform (Quota 100) and the citizenship income (*Reddito di cittadinanza*).¹¹

This is not the time for restrictive policies, but a reversal of Quota 100 would not have contractionary effects even if implemented now. Paradoxically, the citizenship income – a misguided policy when it was implemented – can now be used to reach people that are not covered by the government emergency measures listed above. The government should, however, commit to cancel it when the economy starts recovering.

¹¹ The annual cost of these policies is estimated to range between €9 and €14 billion per year. Over two years, their cost is thus similar to the emergency package just launched by the Conte government.

In countries with high levels of debt, the quality of policies is an important driver of country risk (Ubide, 2020). Quota 100 and the *Reddito di Cittadinanza* are bad policies; the reversal of these misguided policies would be good economics. The problem is that it may be bad politics, as they are very popular and supported by both the Lega and the Five-star Movement. There is thus an important trade-off: implementing the right economic policy may affect Italy's delicate political equilibrium in a period when preserving political stability is paramount.

To avoid the need to reinstate strict containment policies, it is necessary to implement massive testing and tracking aimed at protecting the most vulnerable (seniors and those with existing conditions) and safeguard the national healthcare system.

Second, policymakers need to acknowledge that the medical community does not yet know whether contracting the virus makes people immune in the long term (this is the case for the measles virus, but it is not the case for other viruses like dengue). Hence, herd immunity policies may not work. A vaccine is at least one year away; strict containment policies cannot last that long. After these policies are relaxed, the virus will continue to circulate, and we may observe a second peak of the epidemic curve in the autumn or winter of 2020. To avoid the need to reinstate strict containment policies, it is necessary to implement massive testing and tracking aimed at protecting the most vulnerable (seniors and those with existing conditions) and safeguard the national healthcare system.

After a few days of initial confusion, the Italian authorities did well to take decisive action. As mentioned above, this had positive spillovers for neighbouring countries. It is now time to prepare for the post-emergency period.

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